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IN THE

Supreme Court of the United States

OCTOBER TERM, 1963

No. 183

WALTER A. SHEAFFER, II, ET AL.,
PETITIONERS,

v.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT.

REPLY BRIEF FOR PETITIONERS

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1. It is possible to be misled by the Government's statement that the taxpayers have failed to make the argument which "carried the day" (Op. Br. 8) in *Commissioner* v. *Estate of Morgan*, 316 F.2nd 238 (6th Cir. 1963), affirming 37 T.C. 981 (1962). There is no justification for such a statement. The implication seems to be that the taxpayers have neglected to preserve in the Court below their right to argue for *Morgan* treatment of the $66,892.96 used here for loan

repayment.[1] Obviously that is not the case. It is a fact that we seek a complete reversal of the Court below, not just a partial victory. Nevertheless we point out here, as we did in the Court below, that the Commissioner has attacked the taxpayers on two fronts—income used to pay the gift tax, and subsequent income used to repay a loan; that attributing income to the taxpayers is less defensible on the one front than on the other; and that this case is more conspicuously in conflict with *Morgan* on the one front than on the other.

We pointed out these two aspects of this case and our attitude with respect to them on page 9 of our brief in the Court below when we said:

> "In this case the Tax Court did what it refused to do in two other cases by taxing the settlor on income used to repay a loan for which the settlor

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[1] The $327,307.04 gift tax was paid with the following classes of funds:

(a) $188,607.04 of trust income accumulated (1954 and 1955) prior to the time of the gift tax payment;

(b) $66,892.96 of borrowed money repaid with income received later in the same year (1955) after the gift tax was paid; and

(c) $71,807.04 of borrowed money repaid the next year (1956) with income of that year; this amount is not involved in this case but is in issue for the later year.

(b) and (c) are identical in principle with the *Morgan* facts and fit the test laid down by *Morgan* that the donor's interest in the property of the trust terminated immediately upon payment of the gift tax. Respondent would distinguish (b) from (c) in that in (b) the income accrued later in the same year that the gift tax was paid; while in (c) the income used to repay the loan accrued in a later year. The time element can only be of importance in determining whether at the time of payment of the gift tax, there was any accumulated income in the trust.

was not liable. Furthermore, the distinction between the use of income in payment of the settlor's debt on the one hand and the use of income to repay a loan which was incurred to pay the settlor's debt on the other hand seems unduly fine," citing *Morgan* and *Keith v. Commissioner*, 45 B.T.A. 644 (1941).

This contention was also made as Point No. 1 of the petition for rehearing in the Court below (See Appendix A).

The Government seems to say that if there is a partial inconsistency between *Sheaffer* and *Morgan*, these taxpayers should not have the benefit of it in the favorable exercise of this Court's discretion because of the taxpayers' assertion of a total inconsistency. No reason is advanced, nor is any apparent, why this should affect the Court's discretion.

2. It simply is not true that the Sixth Circuit has rejected our main contention regarding trust income applied to payment of gift tax, thus placing it "plainly in agreement" with the Eighth Circuit (Op. Br. 8). Of course the Eighth Circuit has rejected our contention. But the full Tax Court in *Morgan* did not reconsider the correctness of its single judge decision in *Sheaffer* (erroneously in our opinion) because of the difference between the cases. In affirming, the Sixth Circuit also avoided the issue.

3. The Government can have but little enthusiasm for its *new* role of reconciler of *Sheaffer* and *Morgan* on the grounds that in *Sheaffer*: (1) income of $188,607.04 was applied toward payment of the gift tax; and (2) income of $66,892.96 was, as in *Morgan*, received after the gift tax had been paid and applied

on repayment of a loan, but, unlike in *Morgan*, it was received before the end of the same taxable year in which the gift tax was paid.

The Government showed no indication of satisfaction with the first distinction when it said on page 30 of its *Sheaffer* brief before the Eighth Circuit:

> "The difficulty with the decision in the *Estate of Morgan* is that the substance of that transaction, as evidenced by what actually occurred, is that trust income of subsequent years could have been, and actually was, indirectly used by a nonadverse party for the benefit of the grantor.";

or when it said on page 6 of its brief in *Morgan* before the Sixth Circuit:

> "No different results should follow with respect to the grantor's taxability of trust income because of the intervention of the bank loan, obtained for her benefit."

The second distinction is indefensible, and the Government does not attempt to defend it except by trying to key the rationale of *Morgan* to the fact that the trustee's discretion "had been extinguished before the controverted taxable year had even opened" (Op. Br. 7). Such a test does not make sense. As the Tax Court put it in *Morgan* (Pet. 35a), "the decedent's [grantor's] interest in the property of the trust terminated immediately upon the payment of the gift tax."

4. The Government now seems to agree with us that standards of constructive receipt are the same in trust and non-trust cases, but now apparently contends that a donee's payment of gift tax is necessarily income

to the donor (Op. Br. 5-6).[2] There are situations where the payment of a person's tax liabilities by another constitutes income. The relationship of the parties may signify that the only theory on which one person can be paying the debts of another is in terms of a taxable transaction such as salary (*Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 [1929]), or rent (*United States* v. *Boston & Maine R. Co.*, 279 U.S. 732 [1929]). But the donee of a gift is no interloper with respect to the gift tax. He is the person for whose benefit the donor gratuitously incurs a tax liability, just as the donors in *Edwards* v. *Greenwald*, 217 F. 2d 632 (5th Cir. 1954) (quoted Pet. 14-15), gratuitously incurred another kind of liability for the benefit of their donees. He (the donee) and the gift he received are also liable for satisfaction of the tax obligation. His interest in the tax is every bit as close as the donor's.

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[2] In citing *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (Op. Br. 6), in support of his attempted answer to our claim that income does not arise from discharge of an obligation gratuitously incurred, respondent overlooks what this Court said on page 729:

> "The payment of the tax by the employer was in consideration of the services rendered by the employee and was a gain derived by the employee from his labor."

The Court then continues on page 730:

> "Nor can it be argued that the payment of the tax in No. 130 was a *gift*. The payment for services, even though entirely voluntary, was nevertheless *compensation within the statute*." (Emphasis supplied.)

In the instant case, there was no "compensation" for services, and there was "a gift"; the obligation to pay the gift tax was gratuitously incurred by donor on condition that the donee assume and pay that same obligation. In *Sheaffer*, both donor and donee incurred the same amount of liability on the same date—the date of gift, February 2, 1954—although different dates were fixed by the federal collection statutes as to when the liability of each would ripen into an obligation to pay.

5. The Government suggests (Op. Br. 6) that it would be inappropriate for this Court to grant *certiorari* to resolve a conflict between the Eighth Circuit's decision in this case and the same Court's holding in *Ruben* v. *Commissioner*, 97 F. 2d 926 (8th Cir. 1938). We do not ask the Court to do so. We simply cite *Ruben* and analogous cases as correct statements of the law that should have been applied to this case.

6. The Government's citation of *Mississippi Valley Trust Co.* v. *Commissioner*, 147 F. 2d 186 (8th Cir. 1945) (Op. Br. 5) as standing for the proposition that the donor's gift tax liability is "primary" as between himself and the donee is inexplicable in view of that Court's statement:

> "Only in the sense that the tax is owing in the first instance from the donor, and that the liability of the donee does not arise unless the donor fails to make payment of the tax by the 15th day of March following the close of the calendar year, and that such liability on the part of the donee is limited to the extent of the value of the gift, can the donee's liability be said to be secondary or qualified. If the donor fails to pay the automatically imposed tax when due, in accordance with the statute, no matter what the reason for his failure, there is an immediate and direct liability on the donee for the legally owed tax, to the extent of the value of the gift." 147 F. 2d 186, 187-8.

CONCLUSION

In the aftermath of the Sixth and Eighth Circuit decisions tax lawyers and trust companies are in a state of frustrated confusion and some of their clients may be receiving bad advice.[3] Only a decision of this Court can illuminate this area of the Internal Revenue law by recognizing the underlying realities in transactions like the one in this case.

Respectfully submitted,

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[3] See 7 Commerce Clearing House Standard Federal Tax Reporter, paragraph 8507 (July 17, 1963), which gives the dubious advice to practitioners that trustees should rely on the Government's asserted distinction between *Sheaffer* and *Morgan* and arrange to borrow money and pay their gift taxes if possible in a year before the year in which they will receive income; but then realistically concludes that this too will probably be challenged by the Government. (See Appendix B.)

APPENDIX A

Petition for Rehearing

Filed by petitioners in the Court below, *Estate of Craig R. Sheaffer, Deceased, et al. v. Commissioner*, No. 17,075, September Term, 1962.

(Copy of Point 1, at pages 2-3)

1. At three different places in its opinion (pages 4, 10 and 11) this Court has evidenced its misunderstanding of certain basic facts.

On page 4, the Court stated that the $115,500 in dividends received by the trustee in 1955 were applied by the trustee toward payment of the gift tax. In so stating it lost sight of the fact that dividends of only $52,500 were received by the trustee prior to March 14, 1955, the date of the payment of the gift tax. (See Pet. Br. 9, 28).

Again, on page 10, the Court recognized that the gift tax obligation was discharged "partially with the 1954 and 1955 trust income", but it failed to realize that less than one-half of the 1955 trust income could have been used for that purpose.

On page 11, the concluding sentence of the Court's opinion reads as follows:

> "What the trustee received as trust income and applied to payment of the gift tax, the Sheaffers in reality constructively received, and on that the petitioners must be taxed."

But this Court failed to realize that the Sheaffers would be taxed not only on dividends received and used in payment of the gift tax, but also on money borrowed by the trustee.

This Court, on page 10, in discussing *Estate of Morgan*, 37 T.C. 981 (1962), did "not regard *Morgan* as controlling or dispositive of the issues presented", in the *Sheaffer*

case. But the Court overlooked the fact that the basis for the *Morgan* decision was that the trust income there in issue was received *after* the gift tax was paid.

The effect of the Court's decision would be to tax to petitioners dividends received by the trustee *after*, as well as prior to, the date of payment of the gift tax.

APPENDIX B

Under date of July 17, 1963, after the petition herein was filed, Commerce Clearing House issued a bulletin (7 Standard Federal Tax Reporter, paragraph 8507) containing a discussion of the *Sheaffer* and *Morgan* decisions, concluding with the following paragraph:

> "Distinction Is Difficult
>
> "The distinction between the decisions is difficult to discern, especially since in *Morgan* the Tax Court said that the grantor's interest in the trust property terminated immediately upon payment of the gift taxes. If this be the key to the decision, it seems inconsistent with the holding in *Sheaffer* that dividends received by the trust in the same taxable year that the gift taxes were paid, but presumably received after the date on which the taxes were paid, were used for the grantor's benefit. Perhaps the real distinction lies in the fact that in one case income was actually received by the trust before, and during, the year in which the gift taxes were paid. In the other case, there was no question (or mention) of receipt of income by the trust, but of effect of payments made by the trust. The best tax procedure, then, under these decisions, is to require or have the trust borrow money to pay gift taxes, making sure not to repay the loan until a later year. However, one can well expect the Commissioner to again contest such procedure in the courts. Back reference ¶3749.1816."

We refer to this Bulletin to show this same uncertainty on the part of an organization as useful to, and as much

relied upon by, trust departments of banks and trust companies, and the legal profession in its tax practice, as is the Commerce Clearing House; and more important, to show a most serious error of C.C.H. in its recommendations concerning *Sheaffer* and *Morgan*. The next to the last sentence of the bulletin first recommends that "the trust borrow money to pay gift taxes * * *". This is sound advice under *Morgan* but bad advice under the Eighth Circuit *Sheaffer* decision on the $138,700.00 borrowed. (This borrowed amount included both the $66,892.96 of borrowed money repaid in 1955, see paragraph (b) of our footnote 1 (p. 2, *supra*), plus the $71,807.04 of borrowed money repaid in 1956, see paragraph (c) of same footnote.) C.C.H. then completes its recommendation with the admonition: "making sure not to repay the loan until a later year." That advice can only arise from the fears by C.C.H. of respondent's fanciful distinction as to the importance of the year of repayment.

C.C.H. is in effect telling each subscriber that he can set up a trust under which his client can make a gift in 1963. The trustee can borrow sufficient money prior to April 15, 1964, to pay the gift tax regardless of how much income has been accumulated in the trust prior to April 15, 1964, and no income taxes will be asserted against the grantor provided that no payments are made on the loan until 1965. But then C.C.H. withdraws this assurance in its final sentence,—possibly because of a realization of the true nature and full extent of the Commissioner's proposed restriction that the gift tax must be paid off before the taxable years had even opened.

In making this dubious recommendation, C.C.H. recognizes the true basis of the *Morgan* decision when it says, "in *Morgan* the Tax Court said that the grantor's interest in the trust property terminated immediately upon payment of the gift taxes." Nevertheless, C.C.H. declines to accept the rationale of the *Morgan* case simply because as stated, in the next sentence by C.C.H. "it seems inconsistent with the holding in *Sheaffer* * * *"